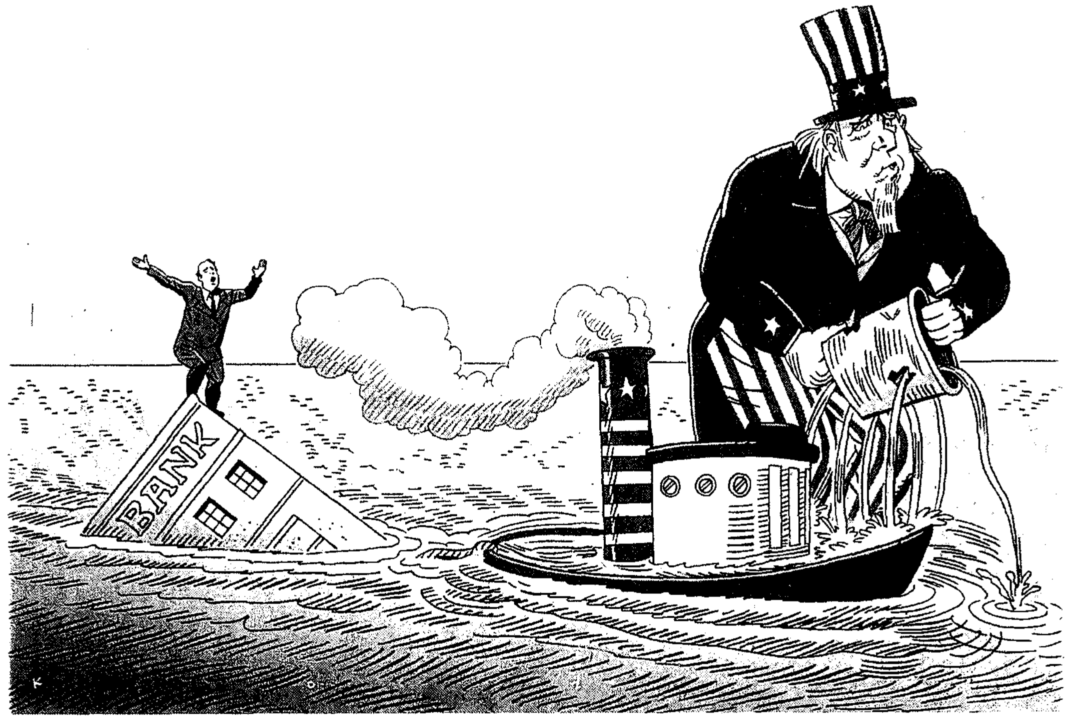
OPINION

How to Avoid a 'Bailout Bill'

By John B. Taylor



Martin Kozlowski

It's good news there's now bipartisan agreement that the financial reform bill should not be a "bailout bill," and that amendments to Connecticut Sen. Chris Dodd's draft legislation are being proposed and debated with this agreement in mind. The biggest challenge in this bailout reform debate is to avoid giving the federal government more discretionary power, whether by creating a special bailout fund or by providing more ways to bypass proven bankruptcy rules. Experience shows that such power would increase, not decrease, the likelihood of another crisis.

Some say that the government did not have enough power to intervene with certain firms during the financial crisis. But it had plenty of power and it used it, beginning with Bear Stearns. This highly discretionary power—to bail out some creditors and not others, to take over some businesses and not others, to let some firms go through bankruptcy and not others—was a major cause of the financial panic in the fall of 2008. The broad justification used for the bailout of Bear Stearns creditors led many to believe the government would again intervene if another similar institution, such as Lehman Brothers, failed.

But when the Federal Reserve and the Treasury Department could not persuade private firms to provide funds to Lehman to pay its creditors in September 2008, the Fed surprisingly cut off access to its funds. The examiner's report on Lehman makes it very clear there was no preparation for bankruptcy proceedings before the day the government suddenly cut off the funds. No wonder there was a disruption.

> A new bankruptcy process is the right way to deal with failing financial institutions.

Then, the next day, the Fed reopened its balance sheet to make loans to rescue the creditors of AIG, including billions for Goldman Sachs. The funding spigot was then turned off again, and a new program, the Troubled Asset Relief Program (TARP), was proposed. This on-again off-again policy was part of a series of unpredictable and confusing government interventions which led to panic.

This experience demonstrates why it is dangerous for the "orderly liquidation" section of the Dodd bill to institutionalize such a process by giving the government even more discretion and power to take over businesses; the interventions are likely again to cause more harm than good, even with the best of intentions. Many experts doubt the ability of the Federal Deposit Insurance Corp. (FDIC) to take over large, complex financial institutions, as the current bill calls for, without causing disruption.

The moral hazard associated with protecting creditors will continue even if the FDIC has the discretionary authority to claw back later some of the funds it provides in the bailout. The proposed liquidation process would have the unintended consequence of increasing the incentive for creditors and other counterparties to run whenever there is a rumor that a government official is thinking about intervening. Who is going to be helped? Who is going to be hurt? It is up to government officials to decide, not the rule of law.

Fortunately, it is not necessary to provide this additional discretionary authority. During the past year since the administration proposed its financial reforms, bankruptcy experts have been working on a reform to the bankruptcy law designed especially for nonbank financial institutions. Sometimes called Chapter 11F, the goal is to let a failing financial firm go into bankruptcy in a predictable, rules-based way without causing spillovers to the economy and permitting, if possible, people to continue to use its financial services—just as people flew on United Airlines planes, bought Kmart sundries and tried on Hartmax suits when those firms were in bankruptcy.

What would a Chapter 11F amendment look like? It would create a special financial bankruptcy court, or at least a group of "special masters" consisting of judges knowledgeable about financial markets and institutions, which would be responsible for handling the case of a financial firm.

In addition to the normal commencement of bankruptcy petitions by creditors or debtors, an involuntary proceeding could be initiated by a government regulatory agency as prescribed by the new bankruptcy law, and the government would be able to propose a reorganization plan—not simply a liquidation. Defining and defending the circumstances for such an initiation—including demonstrating systemic risk using quantitative measures such as interbank credit exposures—is essential.

Third, Chapter 11F would handle the complexities of repurchase agreements and derivatives by enabling close-out netting of contracts in which offsetting credit exposures are combined into a single net amount, which would reduce likelihood of runs.

Fourth, a wind-down plan, filed in advance by each financial firm with its regulator, would serve as a blueprint for the bankruptcy proceedings.

The advantage of this bankruptcy approach is that debtors and creditors negotiate with clear rules and judicial review throughout the process. In contrast, the proposed "orderly liquidation" authority in the current bill is secretive and potentially capricious. Rather than a government official declaring "we will wipe out the shareholders" or "it's unfair for us to claw back so much from creditors," under Chapter 11F the rule of law applies.

A discretionary punishment can be just as harmful as a discretionary bailout. As George Shultz puts it in the book "Ending Government Bailouts As We Know Them," recently published by the Hoover Press, "Let's write Chapter 11F into the law so that we have a credible alternative to bailouts in practice."

What are the obstacles to following this sensible advice? One is that the proposals are new; much of the creative work was done in the past year since the administration first made its reform proposals. A common perception is that bankruptcy is too slow to deal with systemic risk situations in a large complex institution, but the new proposals would have a team of experts ready to go.

Another obstacle is that the Judiciary Committee rather than the Banking Committee has jurisdiction over bankruptcy law, and it is too hard to coordinate. But bureaucratic silos should not get in the way when the stakes are so high.

Yet another hurdle to reform is that the current bill was put together by many of the same people who were in government at the time of the bailouts. A typical government excuse for the crisis is that government did not have enough power, but a more likely explanation is that it had too much discretionary power and, as is so often the case, did not use it effectively.

You do not prevent bailouts by giving the government more power to intervene in a discretionary manner. You prevent bailouts by requiring adequate capital based on simple, enforceable rules and by making it possible for failing firms to go through bankruptcy without causing disruption to the financial system and the economy.

Mr. Taylor, a professor of economics at Stanford and a senior fellow at the Hoover Institution, is co-editor with Kenneth Scott and George Shultz of "Ending Government Bailouts As We Know Them" (Hoover Press, 2010).